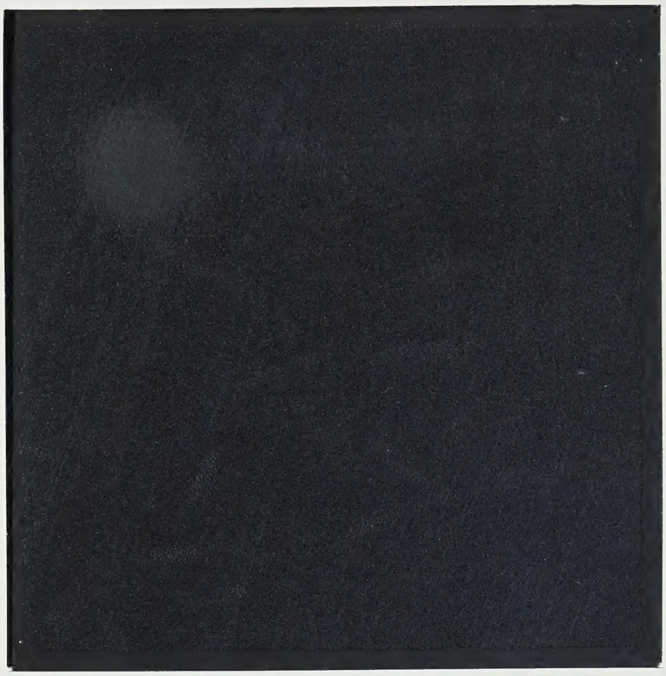
SMALL BUSINESS ADVOCACY REPORT NO. 12

SMALL BUSINESS CAPITALIZATION AND PROPOSED PENSION INVESTMENT REFORMS

August, 1986

MINISTRY OF INDUSTRY, TRADE AND TECHNOLOGY
ONTARIO



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SMALL BUSINESS CAPITALIZATION AND PROPOSED PENSION INVESTMENT REFORMS

August, 1986

Prepared by Stephen Orsini

Small Business Branch
Small Business, Service Industries
and Capital Projects Division
Ministry of Industry, Trade and
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SUBMISSION TO:

PENSION COMMISSION OF ONTARIO

regarding

"POLICY RECOMMENDATIONS FOR THE REGULATION OF PENSION FUND INVESTMENTS"

We, at the Small Business Branch of the Ontario Ministry of Industry, Trade and Technology, agree in principle with the policy thrust of your proposed investment reforms to Ontario's Pension Benefits Act. The adoption of the "prudent person approach" is viewed as an important step to improving small business access to capital. It is our understanding that the revocation of the "legal list" approach would expand the universe of eligible investments so as to now include more small businesses.

We are encouraged by the results of similar changes made to U.S. legislation which have had a significant impact on venture capital formation. Changes made to the U.S. Employee Retirement Income Security Act (ERISA) in 1978 removed the legal list approach and allowed pension funds to invest a relatively small fraction of fund assets in more risky ventures.[1] State pension funds quickly followed suit. As of 1984, private and public pension funds were the single largest source of new venture capital commitments and their share of total venture investments has grown considerably since 1978 (Chart 1).

It is worth noting that pension funds provide an important source of venture capital to small business, as pension funds are large enough to spread the risk of a number of investments to generate relatively high returns. This has been demonstrated by the high returns of the Canadian and U.S. venture capital industries.[2] The problem is, however, small investments require about the same amount of resources to assess and administer as large investments.

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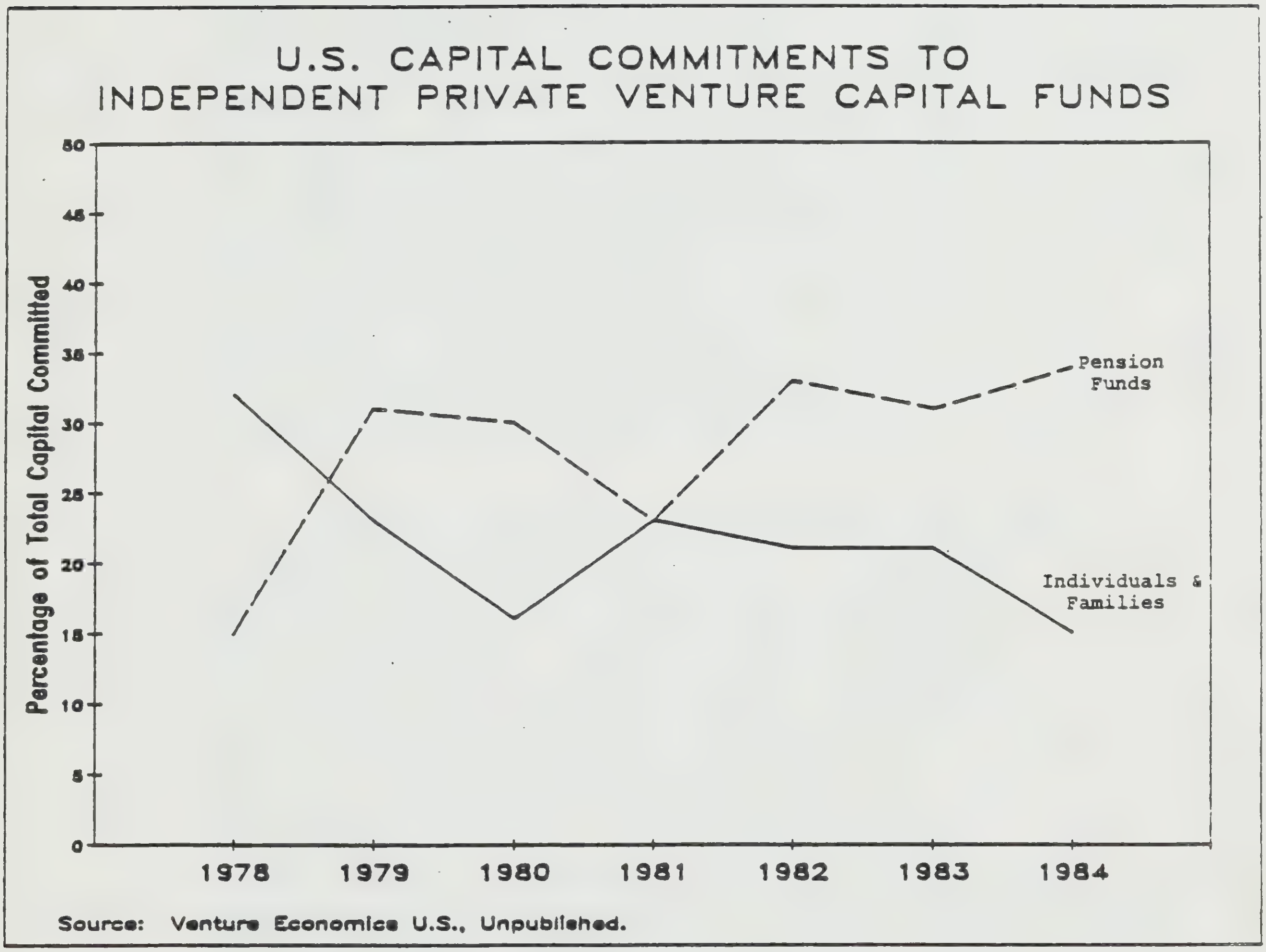
CHART 1



Historically, individuals and families were the single largest source of venture capital funds. However, with the deregulation of investment rules for pension funds in 1978, pension funds were then able to use their large pools of capial to invest in high yielding, high risk ventures. Since then, pension funds appear to have displaced individuals and families as the primary source of venture capital. The dip in pension fund commitments as a percent of total commitments in 1981 is partially due to the surge of investments by taxable entities as a result of the reduction of the U.S. capital gains tax in 1981 from 28 percent to 20 percent. Regardless of the drop in the tax on capital gains, pension funds remain the dominate force in venture capital formation.

Consequently, pension fund managers tend to be biased towards larger investments, as the transaction costs per dollar invested are lower. Given the growth of financial and market intermediaries in Canada and the development of investment networks, such as the Computerized Ontario Investment Network which matches investment opportunities with investors, it is hoped that the transaction costs in investing in small businesses will continue to decline. This in turn should further facilitate pension fund investments in small businesses. We must therefore ensure that our regulatory environment is capable of facilitating venture capital activity as it continues to develop.

Although we endorse the prudent person approach in principle, we are concerned that a requirement in the proposed reforms could counteract any benefits accruing to small businesses. Our main concern pertains to the requirement that pension funds be restricted to no more than 10 percent of voting interests of an investee, unless there is "substantial evidence" that the fund is not in a position to exercise "significant influence". As we understand it, a pension fund could conceivably own more than 10 percent of the voting interests of an investee, if, for example, there is a principal shareholder with more than 50 percent of the voting interests. In such a case, one could argue that the fund was not in a position of significant influence.

We are concerned, however, that the 10 percent ownership restriction will become a hard and fast rule, regardless of the significant influence test. In order to exceed 10 percent of a company's voting shares, a fund

must be satisfied that it does not possess significant influence over the company. Because the proposed reforms do not attempt to define what is precisely meant by significant influence, most funds may not wish to exercise this test, especially for small investments, as it could be challenged in the courts. Furthermore, it is possible to possess significant influence over an investee with less than 10 percent voting interest. A pension fund could own 2 percent of the voting interests and have significant influence, if, for example, there were two other shareholders with 49 percent each. In this case, the pension fund could sway the vote either way.

As noted earlier, the transaction costs per dollar invested tend to be higher for smaller investments. Should the 10 percent limit on voting interests become a hard and fast rule, it would force funds to invest a small proportion of what is already a small investment to begin with. This would act as an investment constraint to capital flowing to small businesses.

The proposed reforms do stipulate that the 10 percent restriction would only apply to voting interests of the company and not to non-voting shares. However, given the risky nature of small business investments and the need for pension funds to maximize liquidity, it is our view that most funds would tend to restrict themselves to voting shares which are generally more attractive than non-voting shares.

We would therefore recommend that consideration be given to including a special "tiering" provision for investments in small businesses. We suggest that pension funds investing in businesses with total assets under $35 million would be permitted to own up to 30 percent of voting interests of a company. Funds owning more than 30 percent of voting interests would then be subject to the significant influence test.

While setting any ceiling can be regarded as an arbitrary measure, we have proposed the above criteria for the following reasons. The $35 million ceiling in total assets is consistent with the federal governments recently enacted investment regulations governing registered pension plans. According to the regulations, to qualify under the Income Tax Act, total assets of eligible corporations (and all associated corporations) may not exceed $35 million.[3] In addition, businesses with total assets under $35 million would also qualify under Ontario's proposed Employee Share Ownership Plan (ESOP), which currently limits total assets of eligible corporations to $50 million.[4] It is imperative that proposed changes to investment regulations in the Pension Benefits Act be consistent with general government policy and other legislation governing investments.

The 30 percent limit on voting interests has been proposed as a compromise between the current proposal and federal regulations governing RRSP investments in eligible small businesses. The federal government limits RRSP investments to 50 percent of the voting shares of an eligible corporation for investments under $25,000. This

special provision to the 10 percent limit of voting shares was made to facilitate RRSPs/RRIFs investments in small businesses. We ask that a special provision be incorporated in Ontario's Pension Benefits Act to complement those of the federal government.

We recognize that allowing greater ownership may increase the possible infuence a pension fund manager has over the small business. This would not, however, conflict with the general requirement that pension funds be "passive" investors. If necessary, pension fund managers could be limited to exercising their voting rights to policy or material issues only. The fund manager would not be involved in the actual day-to-day activities of the business. This strikes an important balance between the need many small businesses have for management advice and the general desire of many small businesses to retain control of the business.

Given the above, we propose that recommendation 6(b) of the proposed policy recommendations be revised to include an exception to the 10 percent limit of voting interests. We recommend that pension funds be restricted to 30 percent of voting interests of businesses with total assets (including all associated companies) under $35 million, unless there is substantial evidence that no significant influence would be exercised should this limit be exceeded.

NOTES

1. Michael Barker (ed.) "Must We Burn Gilder? Or, Taxes and The Entrepreneur" Politics & Markets (Washington, D.C.: The Gallatin Institute, January 31, 1985).

2. Anthony Brown & Gordon Sharwood. Venture Capital in Canada (Toronto: Grieve, Horner & Associates and Sharwood & Company Ltd., 1985: 9).

3. Department of Finance, "Investment in Small Business By Pension Plans", Release (Ottawa, April 2, 1986) and "Investment in Small Business By Pension and Other Retirement Plans - Draft Legislation Released", Release (Ottawa, November 1, 1985).

4. Ontario, Ministry of Treasury and Economics. 1986 Ontario Budget (Toronto, May 13, 1986) Appendix 4: Employee Share Ownership Plan (ESOP).

Ontario Ministry of Financial Institutions

Ministère des Institutions financières

News Release

July 4, 1986 POLICY RECOMMENDATIONS ON PENSION FUND INVESTMENT REGULATIONS RELEASED FOR COMMENT

Ontario Minister of Financial Institutions, Monte Kwinter, today released for comment, policy recommendations on the regulation of pension fund investments.

Mr. Kwinter said under the proposals, "We are recommending strict rules governing conflict-of-interest and self-dealing as well as disclosure of specific investment and financial information to members of pension plans with 50 or more members."

At the same time, the recommended regulations would allow fund managers greater freedom and flexibility in making investment decisions while still protecting the interest of the beneficiaries, he said.

The changes would also create the potential for pension plans to increase investment in small business within the overall requirement for prudency.

.../2

The recommendations centre on a 'prudent person' approach which requires the fund manager to act with care, skill, prudence and diligence, under the guidance of specific restrictions and requirements. Current investment legislation for pension funds relies heavily on a prescribed list of qualified investments.

Other key regulations being recommended would:

- require the establishment of written investment goals and objectives;
- eliminate current tests and 'ineligible investment' clauses which have been described as artificial and limiting factors in overall portfolio quality;
- ensure diversification to prevent an entire pension fund being put at risk through concentration on, for example, one investment;
- ensure pension fund investment is limited to that of a passive investment risk so as not to exert significant influence over private sector companies;
- require annual audits, by a public accountant, for pension funds with 50 or more members;

.../3

- impose penalties for imprudence; and,

- permit the Superintendent to institute legal action for imprudent investment.

The Minister said: "These policy positions should create a system which will work well and safely, with a minimum of supervision. They also represent a continuation of our effort to achieve uniformity of pension plan regulations across the country. They have been developed by Ontario's Pension Commission after discussions with the federal and other provincial governments, as well as members of the investment community and various interest groups."

The government has undertaken a large mailing of the policy recommendations to groups and individuals who will be affected by the proposed regulations. Those wishing to comment are asked to do so in writing by August 29,1986 to:

The Office of the Superintendent
Pension Commission of Ontario
101 Bloor Street West, 9th Floor
Toronto, Ontario
M7A 2K2

.../4

If clarification or advice is required, please contact the Assistant Superintendents, Mr. Ignas Nastajus or Ms. Lynda Ellis, at (416) 963-0522.

Additional copies of the policy recommendations are available from the Office of the Superintendent.

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Reference: Pat Inett (416) 963-0339

EDITOR: Please see attached for full details of 'Policy Recommendations for the Regulation of Pension Fund Investments'.

PENSION COMMISSION OF ONTARIO

Policy Recommendations for the Regulation of Pension Fund Investments

Released July 4, 1986

PART A

1) INTRODUCTION

The current Ontario Pension Benefits Investment legislation existed, with the exception of minor housekeeping adjustments, unchanged from 1965 to 1982. At that time regulations regarding pooled real estate funds were added. In 1984 regulations dealing with investments in resource properties and credit insurance were passed.

The current legislation relies heavily on specific quantity and quality tests, prohibitions and on certain exceptions. It is also "piggy-backed" on the Canadian and British Insurance Companies Act and the Loan and Trust Companies Act.

Although the Federal Government and other provincial regulations used the same approach in regulating pension fund investments, there has been an increasing lack of uniformity in the application of investment standards across the country.

The need to balance the overall portfolio, hedge certain risks and to provide appropriate returns have put pressure on the investment community to develop new forms of investments and new investment strategies.

The adoption of the prudent person approach in the United States with its move away from the traditional quantity and quality tests and restrictions have brought pressure to bear on the Commission to give consideration to the adoption of a similar approach in Ontario.

These factors along with suggestions from investment fund managers and the investment community have caused the Pension Commission of Ontario to review its existing legislation respecting pension fund investments.

At its meeting of 7 February 1985, the members of the Pension Commission, acknowledging the urgency of an official Ontario position in pension plan investment matters, established an investment subcommittee and directed the subcommittee to meet in order to carry out the Commission's directives.

The Commission directed the Subcommittee to:

- review and assess the changes needed to the investment regulations of the Pension Benefits Act;
- review and assess the opinions, suggestions, requirements and proposed legislation of other jurisdictions;
- address uniformity of investment legislation;
- study and make recommendation with respect to the prudent person approach to investments;
- meet with representatives of the public, industry and other outside agents;
- report back to the members of the Commission with its recommendations.

The Subcommittee held meetings with

- federal and provincial pension regulators,
- investment counsellors, securities lawyers and representatives of

  trust companies,

  the Canadian Life and Health Association,

  the Toronto Futures Exchange,

  The Canadian Labour Congress,

  The Canadian Depository Service.

Concurrently, various jurisdictions, most notably those of Ontario, Quebec and the federal government, conducted surveys and studies on the current needs and requirements of the loan and trust industry, the insurance industry and the pension investment community.

Although there have been discussions among the regulatory bodies there are differences in their positions. Within our study we have focused most notably on the Federal and Quebec positions.

PART B

PENSION COMMISSION OF ONTARIO

Recommendation on the Regulation of Pension Fund Investments

Proposed Legislation

The Pension Commission of Ontario proposes to adopt the "prudent person approach" for the investment of pension fund assets subject to the Ontario Pension Benefits Act.

Although the proposed Pension Benefits Act, 1986, does not address the matter of investments in detail, it does contain certain references to "prudence" and "reasonableness", in other areas such as:

a) the prudent and reasonable supervision by administrators of appointed persons or agents, whatever the function of the latter group may be.

b) a general prohibition against conflicts of interest.

c) a requirement for administrators to exercise the degree of care, diligence and skill that a person of ordinary prudence would exercise in administering a fund.

d) a requirement that administrators with relevant knowledge or skills employ these in administering a fund.

The Commission also recognizes that if the prudent person approach were adopted without any other constraints, a strong regulatory body would be required to monitor the investment of pension fund assets.

However, it is the preference of the Commission to have a system that works well and safely while keeping monitoring to a minimum.

Since the Commission is unaware of any self-regulatory bodies in the investment community it therefore must recommend the adoption of the prudent person approach with some restrictions in certain specified areas. In addition to these restrictions the requirement for disclosure of certain information concerning investments to the members of pension plans, audits of the pension fund and an expansion of the Commission's power should permit the operation of the fund with a minimum of supervision.

It is felt that these requirements will:

- allow fund managers greater freedom and flexibility in making investment decisions;
- eliminate quality tests and the "basket" clauses;
- ensure diversity by retaining quantity tests;
- impose penalties for imprudence;
- ensure that there are strict rules governing conflict-of-interest and self-dealing;
- ensure pension fund investment is limited to that of a passive investment risk;
- require annual audits of certain funds;
- require disclosure of certain investment and financial information to the members of a pension plan and to the Advisory Committee;
- permit the Superintendent to institute legal action for imprudent investment;
- require the establishment of written investment goals and objectives.

PART C

MAIN PRINCIPLES AND RECOMMENDATIONS

(1) PRUDENT PERSON APPROACH

Pension fund investment has become increasingly sophisticated and it is desirable that fund managers be able to participate in these investments to hedge risks and balance the portfolio.

Recommendations:

a) The Pension Commission of Ontario adopt the prudent person approach for investments made by pension plans registered in Ontario;

b) The prudent person approach be defined as the exercise of care, diligence and skill in the administration of the fund that a person of ordinary prudence shall exercise in dealing with the property of another person using all relevant knowledge and skill that a person by reason of his or her profession, business or calling ought to possess.

(2) WRITTEN OBJECTIVES AND GOALS

A prudent investment policy must be developed for each plan and be stated as a part of the plan documents. Fund Managers and Plan members should have knowledge of the policy.

Recommendations:

a) The sponsor or administrator of the plan will be charged with the responsibility for establishing the

investment policy for the plan. This policy shall contain specific criteria related to asset mix, investment quality and quantity tests. The policy shall be contained in the pension plan or the investment contract.

b) The establishment of this investment policy will not be required under a fully-insured pension plan.

c) Anyone assuming the responsibilities for administering the pension fund would be required to accept the criteria established under the plan.

(3) QUALITY TESTS AND THE BASKET CLAUSES

The current tests and basket clauses have been described as artificial and limiting factors in overall portfolio quality and have been criticized as preventing plans from investing according to the best interests of plan members.

However, despite the implicit onus of prudence embodied in the current law, some pension fund managers have relied upon the quality tests and the basket clauses believing that the courts would be reluctant to find a sponsor who conforms to the current tests to have violated the duty of prudence.

Recommendations:

The current quality tests and the basket clauses be eliminated from the Regulations.

(4) DIVERSIFICATION

There is a need to prescribe diversification to prevent a plan sponsor from putting the entire pension fund at risk by concentrating for example on one investment. The following recommendations have been prepared using the current reference to book value of assets. The Pension Commission invites submissions whether the market or actuarial value of assets should be used instead.

Recommendations:

a) The amount that could be invested in the securities of or loans to any business entity be limited to 10% of the total book value of pension plan assets;

b) In the case of a group of related non-publicly traded businesses, that are affiliates as defined under the Ontario Business Corporations Act 1982, the 10% limit shall apply to the entire group;

c) Direct investment in real estate and resource properties be limited as follows:

   i) a maximum of 5% of total book value of plan assets in any one parcel of real estate or resource property;

   ii) a maximum of 15% of total book value of plan assets in resource properties;

   iii) a maximum aggregate amount of 25% of total book value of plan assets in real estate and resource properties.

d) The 10% limit in a) above not apply to pooled, segregated and mutual funds or to certain corporations whose investments are limited to those which a pension plan may make providing the respective pooled, segregated and mutual funds or certain corporations follow the recommendations set out herein.

e) The 10% limit in a) above not apply to issues that are guaranteed by the Government of Canada or a province of Canada.

(5) CONFLICT OF INTEREST

It was generally agreed that potential or actual conflicts of interest and self-dealing are imprudent and should be strictly regulated or in some instances prohibited entirely.

Recommendations:

a) Investments in and/or loans to the plan sponsor be prohibited subject to certain exemptions that may be approved by the Commission.

b) In the case of a group of related, non-publicly traded businesses, that are affiliates as defined under the Ontario Business Corporations Act 1982, the prohibition shall apply to the whole group;

c) Trading of investments between the plan and the plan sponsor be prohibited;

d) Investments by the plan in real estate occupied by or to be developed by the plan sponsor be prohibited;

e) A plan sponsor be permitted to charge the plan assets for ancillary service performed externally, to a reasonable amount; and

f) A plan sponsor be prohibited from charging the plan assets for ancillary services performed internally by its employees.

(6) CONTROL OF PRIVATE SECTOR COMPANIES

It was generally agreed that a pension plan should be a passive investor and not exert significant influence over private sector companies.

Recommendations:

a) Pension funds be required to restrict the risk with respect to investments of the funds to that of a passive investment risk, and they be prohibited from being in a position to exercise significant influence over the operating and financial position of an investee even though they may not legally control the investee;

b) It be presumed that, where a fund holds less than 10% of the voting interest in an investee, the fund does not have the ability to exercise significant influence;

It be presumed that the holding of 10% or more of the voting interest in an investee results in the ability to exercise significant influence unless there is substantial evidence to the contrary;

Substantial or majority ownership by another investor need not necessarily preclude a fund from exercising significant influence;

c) A fund manager be prohibited, unless given specific voting instructions by the plan sponsor, from voting the shares of managed funds;

d) Recommendation c) above be extended to trust companies and insurance companies in their fund management capacities;

e) A fund manager, managing a group of funds which in the aggregate hold more than 10% of the voting rights of an investee, be required to request that the fund trustee or plan sponsor vote the securities so that the manager is precluded from putting himself in a position of exercising significant influence.

(7) OTHER CONSIDERATIONS

Other areas of consideration included securities lending, pension fund borrowing and the holding of assets in a nominee name.

Recommendations:

a) Managers be permitted to loan pension fund investments if the loans are secured by cash or highly liquid securities (Government of Canada Bills) to the extent 110% of the loan;

b) Pension fund borrowing continue to be restricted to short term to avoid a distress sale of assets and that the fund assets not be used as collateral; and

c) All pension plan loans and investments be held in the name of the pension plan.

(8) AUDIT AND DISCLOSURE

All plans are not at present required to be audited nor does current legislation provide the members with access to certain financial and investment information.

Recommendations:

a) An annual audit by a public accountant be required for pension funds with 50 or more members.

b) The audit shall conform to generally accepted auditing standards as contained in the Canadian Institute of Chartered Accountants Handbook.

c) Members of such plans have access to the audited financial statements of their plan's pension fund; and

d) Certain summary information on the fund portfolio be made available to the members.

(9) SUPERVISION BY THE PENSION COMMISSION

In order for the Pension Commission to monitor and ensure that the general principle of prudence is adhered to and that the pension fund's solvency is not impaired, the Commission's current powers need to be broadened.

Recommendations:

a) Appropriate penalties for non-compliance in investment matters be developed;

b) The Superintendent be empowered to take legal or other warranted action in situations where the Commission is of the view that the fund may not have been managed prudently;

c) The Superintendent be empowered to order an administrator to divest the pension fund of a given investment or desist from an action or policy if the Commission has reason to believe that such investment, action or policy is undermining the solvency of the pension fund;

d) The Superintendent have the power to exclude from a fund's asset valuation any investment whose value could not be readily determined;

e) The Superintendent be empowered to call for an independent valuation of any investment where no clear market value exists; and

f) The Superintendent be empowered to charge the cost of such independent valuation to the plan sponsor.